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COMMENTS

CALIFORNIA RENT CONTROL AS APPLIED: ASSESSED VALUE AS A MEASURE OF FAIR RETURN

I. INTRODUCTION

California courts have allowed local governments to exercise considerable discretion in establishing the conditions that warrant the imposition of rent controls. For example, the City of Berkeley enacted rent control on grounds that its residents "have a right to decent housing in pleasant neighborhoods which meet standards of adequacy at a range of prices they can afford."¹ Santa Monica cited "[a] growing shortage of housing units resulting in a low vacancy rate and rapidly rising rents exploiting this shortage" as a justification for its enactment of rent controls.²

The California Supreme Court has consistently held that rent control ordinances designed to combat these problems are a valid exercise of local police power, provided that landlords are ensured "a just and reasonable return on their property."³ The issue of what actually constitutes "a just and reasonable return" or "fair return" has arisen repeatedly in rent control litigation.⁴ Rent control proponents contend that the California Constitution requires only that landlords receive a fair return on their *investment* in rental prop-

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1. BERKELEY, CALIFORNIA, TENANTS RIGHTS AMENDMENT ACT OF 1982, § 2(a) (1982) [hereinafter TENANTS RIGHTS] (citing the Housing Element of the Berkeley Master Plan of 1977), (*reprinted in* RENT CONTROL PROGRAM MATERIAL MAGAZINE, May/June 1985 (CEB 1985)).

2. SANTA MONICA, CALIFORNIA, MUNICIPAL RENT CONTROL ORDINANCE, art. XVIII, § 1800, (*reprinted in* RENT CONTROL PROGRAM MATERIAL May/June 1985 (CEB 1985)). Evidence of a housing shortage, alone, is sufficient to justify the imposition of rent controls. 301 Ocean Avenue v. Santa Monica Rent Control Board, 175 Cal. App. 3d 149, 159, 221 Cal. Rptr. 610, 615 (1985).

3. See *infra* notes 17-18 and accompanying text.

4. See *infra* notes 34-52 and accompanying text.

erty.⁵ Landlords argue that to be just and reasonable, an ordinance must ensure a return which reflects the current *value* of their property.⁶

To date, landlords have successfully challenged only one rent control ordinance.⁷ Generally, their attacks have been limited to facial challenges which allege that the terms of a given ordinance prevent landlords from recognizing a constitutional return. In reviewing such challenges, the California Supreme Court has upheld ordinances as long as their terms allow those who administer the ordinances opportunity to avoid confiscatory results.⁸ In reviewing an ordinance on its face, the court has avoided the issue of whether the "return on investment standard" is a sufficient constitutional measure of the value of a landlord's property. The court has upheld such standards against a facial attack if the terms of the ordinance permit rent boards to set rent levels that allow landlords a fair return.⁹

In addition to a facial challenge, a rent control ordinance may be attacked *as applied* to an individual landlord. To successfully challenge an ordinance, a landlord must demonstrate that the return permitted by an ordinance falls short of the "just and reasonable return on property" the California Supreme Court has held to be constitutionally required.¹⁰ In reviewing a challenge to rent control, the court will have to address the issue of whether a return based on a landlord's investment in property is constitutionally sufficient.¹¹

Presently, no jurisdiction has published an opinion defining the standard by which rents shall be measured for constitutional sufficiency. The New Jersey Supreme Court recognized the need for a constitutional standard, yet it concluded that the question would be best resolved by the legislature.¹² In *Fisher v. Berkeley*,¹³ the Cali-

5. See generally *Fisher v. City of Berkeley*, 37 Cal. 3d 644, 693 P.2d 261, 209 Cal. Rptr. 682 (1984), *appeal dismissed in part*, 471 U.S. 1124 (1985), *aff'd*, 475 U.S. 260 (1986); *Baker v. City of Santa Monica*, 181 Cal. App. 3d 972, 226 Cal. Rptr. 755 (1986), *appeal dismissed*, 107 S. Ct. 1265 (1987).

6. *Fisher*, 37 Cal. 3d 644, 693 P.2d 261, 209 Cal. Rptr. 682 (1984).

7. *Birkenfeld v. City of Berkeley*, 17 Cal. 3d 129, 550 P.2d 1001, 130 Cal. Rptr. 465 (1976); see *infra* notes 34-52 and accompanying text.

8. *Birkenfeld*, 17 Cal. 3d 129, 550 P.2d 1001, 130 Cal. Rptr. 465 (1976).

9. *Fisher*, 37 Cal. 3d at 644, 693 P.2d at 691, 209 Cal. Rptr. at 682; *Carson Mobilehome Park Owner's Ass'n v. City of Carson*, 35 Cal. 3d 184, 676 P.2d 1297, 197 Cal. Rptr. 284 (1983); *Pennel v. City of San Jose*, 42 Cal. 3d 365, 721 P.2d 1111, 228 Cal. Rptr. 726 (1986).

10. See *infra* notes 26-32 and accompanying text.

11. See *infra* notes 26-32 and accompanying text.

12. *Helmsley v. Borough of Fort Lee*, 78 N.J. 200, 394 A.2d 65 (1978), *appeal dismissed*, 440 U.S. 978 (1979).

The court stated "rent control implicates complex economic, social and political issues.

fornia Supreme Court indicated that it would define a standard when faced with a challenge to rent control as applied.¹⁴

This comment will define a standard based upon the assessed value of rental property. In practice, this standard will preclude a landlord from alleging his returns are confiscatory when the property value upon which a rent board computes his allowable return equals or exceeds the property value upon which his tax liability is based. If the rent board computes rent based on a value below the *assessed* value of the landlord's property, the landlord would be entitled to relief.

This comment will first identify the constitutional authority for local rent control ordinances and review specific challenges to the constitutional sufficiency of a rent control ordinance. Next, this comment will consider the methods currently employed by local rent boards to set rents for their applicability as a constitutional measure of returns. Finally, this comment will define a constitutional standard based upon a property's assessed value.

II. BACKGROUND

A. *Constitutional Authority for Local Rent Control Ordinances in California*

A rate-making agency may restrict the income derived by owners from a regulated activity.¹⁵ The degree to which an owner's income may be restricted, however, is subject to constitutional limitations. Courts have consistently held that owners of the regulated industry must be permitted to earn a reasonable return from their properties.¹⁶

The California Supreme Court first addressed the constitutional limitations affecting a rent board's authority to establish rent ceilings

The state legislature is better equipped than most municipalities to formulate a comprehensive approach to this delicate problem." *Helmsley*, 78 N.J. at 224, 394 A.2d at 86.

13. 37 Cal. 3d 644, 693 P.2d 261, 209 Cal. Rptr. 682 (1984).

14. *Id.* at 681, 693 P.2d at 291, 209 Cal. Rptr. at 712.

15. *See, e.g.*, *Southern Cal. Edison Co. v. Public Utils. Comm'n*, 20 Cal. 3d 813, 576 P.2d 945, 144 Cal. Rptr. 905 (1978); *City and County of San Francisco v. Public Utils. Comm'n*, 6 Cal. 3d 119, 490 P.2d 798, 98 Cal. Rptr. 286 (1971); *Penn. Cent. Transp. Co. v. City of New York*, 42 N.Y.2d 324, 366 N.E.2d 1271, 397 N.Y.S.2d 914 (1977), *aff'd*, 438 U.S. 104 (1978).

16. *See, e.g.*, *Southern Cal. Edison Co.*, 20 Cal. 3d 813, 576 P.2d 945, 144 Cal. Rptr. 905 (1978); *City and County of San Francisco*, 6 Cal. 3d 119, 490 P.2d 798, 98 Cal. Rptr. 286 (1971); *Penn. Cent. Transp. Co.*, 42 N.Y.2d 324, 366 N.E.2d 1271, 339 N.Y.S.3d 914 (1977).

in the case of *Birkenfeld v. City of Berkeley*.¹⁷ The court held that rent control is a proper exercise of local government's police power if it is "reasonably calculated to eliminate excessive rents and at the same time provide landlords with a just and reasonable return on their property."¹⁸

In *Birkenfeld*, the California Supreme Court found Berkeley's rent ordinance to be unconstitutional on its face because "its terms [would] not permit those who administer it to avoid confiscatory results."¹⁹ In so finding, the court reasoned that the rent adjustment mechanism provided by the ordinance would inevitably result in unreasonable delays for landlords seeking an increase in rents.²⁰ The court reasoned that "[p]roperty may be as effectively taken by long continued and unreasonable delay in putting an end to confiscatory rates as by an express affirmation of them."²¹

Although the *Birkenfeld* court criticized the administrative method employed by the Berkeley rent board, the court rejected the notion that a particular formula must be used to calculate a just and reasonable return.²² The court found the method of regulating rents to be immaterial, so long as a landlord received a fair return.²³ An ordinance that will inevitably produce confiscatory results will thus be rejected by the court as unconstitutional on its face.²⁴ However, if it appears that the terms of the ordinance will permit those who administer it to avoid confiscatory results, the ordinance will survive a facial attack.²⁵

Two 1984 California Supreme Court rent control decisions,

17. 17 Cal. 3d 129, 550 P.2d 1001, 130 Cal. Rptr. 465 (1976).

18. *Id.* at 165, 550 P.2d at 1027, 130 Cal. Rptr. at 491. The court continued, "if it is apparent from the face of the provisions that their effect will necessarily lower rents more than could reasonably be considered to be required for the measure's stated purpose, they are unconstitutionally confiscatory." *Id.*

The *Birkenfeld* court rejected a variety of challenges concerning a city's authority to control rents. The court found general authority for rent regulation in the "police power" provision of California's Constitution. CAL. CONST. art. XI, § 7 (*Birkenfeld*, 17 Cal. 3d at 140, 550 P.2d at 1009, 130 Cal. Rptr. at 473), rejected a claim that rent control laws are pre-empted by state regulation of landlord-tenant relations (*Id.* at 141, 550 P.2d at 1013, 130 Cal. Rptr. at 474), and held that it was proper for local governments to regulate private relations. *Id.* at 142-43, 550 P.2d at 1011, 130 Cal. Rptr. at 475.

19. 17 Cal. 3d at 165, 550 P.2d at 1027, 130 Cal. Rptr. at 491.

20. *Id.* at 169, 550 P.2d at 1030, 130 Cal. Rptr. at 494.

21. *Id.* (citing *Smith v. Illinois Bell Tel. Co.*, 270 U.S. 587, 591 (1926)).

22. *Id.* at 165, 550 P.2d at 1027, 130 Cal. Rptr. at 491.

23. *Id.*

24. *Id.*

25. *Id.* at 169, 550 P.2d at 1030, 130 Cal. Rptr. at 494.

*Carson Mobilehome Park Owner's Association v. City of Carson*²⁶ and *Fisher*,²⁷ recognized the possibility that an ordinance, although constitutional on its face, may violate the constitutional due process rights of an individual landlord. In both cases the California Supreme Court found that the facial sufficiency of a rent control ordinance, as applied to an individual, must be measured against a different constitutional standard than that prescribed by *Birkenfeld*.²⁸ Similarly, in its most recent rent control decision, *Pennel v. City of San Jose*,²⁹ the court again noted the need for a separate standard to measure an ordinance as applied.³⁰

Although the California Supreme Court has recognized the need for a new standard, the court has indicated that it will address the issue only when it is faced with a challenge to an ordinance as applied.³¹ *Carson* and *Fisher* decisions. *Carson*, *Fisher* and *Pennel* each involved facial challenges. In each case, the court found it unnecessary to define the constitutional standard for measuring the results of an ordinance as applied to an individual landlord.³²

B. Specific Challenges to the Constitutional Sufficiency of a Rent Control Ordinance

In light of the distinction developed in *Fisher*, *Carson* and *Pennel*³³ if a landlord believes a rent ordinance unreasonably restricts his income, he has two options for relief: (1) he may challenge the administrative method employed by the rent board on the grounds it will inevitably generate confiscatory results; or (2) he may challenge the results of the administrative method as applied in his case, by

26. 35 Cal. 3d 184, 672 P.2d 1297, 197 Cal. Rptr. 284 (1983).

27. 37 Cal. 3d 644, 693 P.2d 261, 209 Cal. Rptr. 682 (1984).

28. *Carson*, 35 Cal. 3d at 191-92, 672 P.2d at 1300-01, 197 Cal. Rptr. at 287-88; *Fisher*, 37 Cal. 3d at 681, 693 P.2d at 291, 209 Cal. Rptr. at 712.

29. 42 Cal. 3d 365, 721 P.2d 1111, 228 Cal. Rptr. 726 (1986).

30. *Id.* at 370-71, 721 P.2d at 1114-15, 228 Cal. Rptr. at 729-30.

31. In *Fisher* the court stated in a footnote, "[i]t would be premature and problematic for us to attempt to articulate, in the context of this facial attack, the constitutional test against which specific applications of various administrative standards are to be judged. We will face that question when we review a challenge to rent control as applied to particular plaintiffs." 37 Cal. 3d at 681 n.35, 693 P.2d at 291 n.35, 209 Cal. Rptr. at 712 n.35. The court concluded it would be inappropriate to define the constitutional standard in the context of the facial challenge it was presently reviewing.

32. *Carson*, 35 Cal. 3d at 191-92, 672 P.2d at 1300-01, 197 Cal. Rptr. at 287-88; *Fisher*, 37 Cal. 3d at 681, 693 P.2d at 291, 209 Cal. Rptr. at 712; *Pennel*, 42 Cal. 3d at 370, 721 P.2d at 1114-15, 228 Cal. Rptr. at 729-30.

33. See *supra* notes 26-30 and accompanying text.

invoking the constitutional due process standard.³⁴

California courts have considered a number of facial challenges based on the constitutional sufficiency of the administrative method employed by a local rent board. In *Birkenfeld*, the California Supreme Court held that rent control laws of indefinite duration must permit a rent board to give landlords an opportunity to increase rents to recover costs within a reasonable time.³⁵ The court has suggested two alternative rent adjustment mechanisms to enable landlords to recover these costs: (1) an ordinance that empowers the rent board to grant general rent increases to all landlords; or (2) an ordinance that empowers hearing officers to grant individual increases to particular landlords.³⁶ The court has upheld an ordinance containing both mechanisms,³⁷ as well as one containing only an individual procedure.³⁸

The California Supreme Court, however, has expressly rejected the notion that an ordinance must provide a landlord with a reasonable return on the current market value of his property.³⁹ In *Fisher*, the court held that a standard allowing the landlord to recover a "reasonable return on investment" was sufficient to withstand a facial challenge.⁴⁰ Similarly, lower courts have upheld ordinances that base "reasonable return" upon a landlord's net operating income in a given base year.⁴¹ In *Fisher*, the court suggested a "Net Operating Income Method" (NOIM)⁴² would be acceptable, provided landlords' income was not indefinitely frozen at the nominal amount earned in the base year.⁴³

34. See *supra* notes 26-30 and accompanying text.

35. 17 Cal. 3d at 129, 550 P.2d at 1001, 130 Cal. Rptr. at 465.

36. *Id.* at 170, 550 P.2d at 1040, 130 Cal. Rptr. at 494.

37. *Fisher*, 37 Cal. 3d at 644, 693 P.2d at 261, 209 Cal. Rptr. at 682. The court concluded that combination of the general and individual-adjustment standard was constitutionally sufficient because they permitted the board sufficient flexibility to allow a fair return.

38. *Carson*, 35 Cal. 3d at 184, 672 P.2d at 1297, 197 Cal. Rptr. at 284.

39. *Fisher*, 37 Cal. 3d at 686, 693 P.2d at 295, 209 Cal. Rptr. at 716. The court stated, "[w]e can state with certainty that a rent control ordinance need not provide for a fair return on the value of a landlord's property in order to survive a facial challenge." *Id.*

40. *Id.* (citing *Oceanside Mobilehome Park Owners Ass'n v. City of Oceanside*, 157 Cal. App. 3d 887, 897-900, 204 Cal. Rptr. 239, 245-47 (1984)); *Cotati Alliance for Better Hous. v. City of Cotati*, 148 Cal. App. 3d 280, 288-89, 195 Cal. Rptr. 825, 830-31 (1983).

41. See *Baker*, 181 Cal. App. 3d at 972, 226 Cal. Rptr. at 755; See also *Cotati*, 148 Cal. App. 3d at 280, 195 Cal. Rptr. at 825; *Palos Verdes Shores Mobile Estates, Ltd. v. City of Los Angeles*, 142 Cal. App. 3d 362, 190 Cal. Rptr. 866 (1983).

42. A NOIM approach assumes a landlord's return to be reasonable at a given date. This becomes the base rent. This rent is adjusted each year to compensate for increased costs, and, in some cases, inflation. See, e.g., TENANTS RIGHTS, *supra* note 1, at §§ 10-11.

43. 37 Cal. 3d at 683, 693 P.2d at 292, 209 Cal. Rptr. at 712-13.

Although several landlords have brought suit facially challenging rent control ordinances, only one California court has considered the appropriate standard for measuring the results of an ordinance as applied.⁴⁴ In *Baker v. City of Santa Monica*,⁴⁵ the trial court invalidated Santa Monica's ordinances, concluding that the city's fair return on *investment* standard was unconstitutional because it did not permit a fair return based upon the "market" value of a landlord's property.⁴⁶

In its findings of fact and conclusions of law, the *Baker* trial court found that "landlords were constitutionally entitled to cash returns on their property greater than public utility stocks"⁴⁷ and concluded that a landlord's property value should be calculated by methods similar to these used to set public utility rates.⁴⁸ Under the standard adopted by the trial court, "fair return" was based upon the fair market value of the property on the date controls were imposed.⁴⁹

The court of appeal reversed, holding that Santa Monica's return on investment standard was *facially* constitutional.⁵⁰ Although

44. It is important to again stress the difference between the constitutional sufficiency of an administrative method and the constitutionality of the results of that method as applied to an individual. The fact that a given method is found to be constitutional on its face by no means guarantees that its application would be constitutional in measuring individual results. The New Jersey Supreme Court recognized this distinction between administrative methods and the constitutional standard as applied to individuals but has yet to define the latter. *Helmsley*, 78 N.J. at 200, 394 A.2d at 65; *Troy Hills Village v. Parsippany-Troy Hills Township*, 68 N.J. 604, 350 A.2d 34 (1975). To date, no jurisdiction has published an opinion which defines a method for determining a constitutional "fair return."

45. 181 Cal. App. 972, 226 Cal. Rptr. 755 (1986). The trial court identified the following issue for trial: "Whether the rent control law on its face or as applied satisfied the constitutional standards for 'just and reasonable return on property' as required by the California Supreme Court in [Birkenfeld]." *Id.* at 976, 226 Cal. Rptr. at 757.

46. *Id.* at 976, 226 Cal. Rptr. at 757. After Santa Monica's return on investment standard was invalidated, the city adopted a new ordinance containing a Net Operating Income standard. This standard was upheld in Phase II of the trial. *Id.*

47. *Id.* at 976 n.2, 226 Cal. Rptr. at 757 n.2.

48. *Id.* The rates of a public utility are based upon the value of the property at the time it was dedicated to public use. *But cf.* *Southern California Gas Co. v. Public Utils. Comm'n*, 23 Cal. 3d 470, 474, 591 P.2d 34, 36, 153 Cal. Rptr. 10, 12 (1979).

Baker's attorneys argued by analogy that rental property is "dedicated to public use" at the date rent controls are imposed, and therefore, a landlord's fair return should be based upon the value of his property at that time. This standard is commonly referred to as the Public Utility Investment Standard. Respondent's Opening Brief, *Baker*, 181 Cal. App. 3d at 972, 226 Cal. Rptr. at 755 [hereinafter Respondent's Brief] (on file at the Santa Clara Law Review office). For a more detailed discussion of the Public Utility Investment Standard, *See infra* notes 69-81 and accompanying text.

49. Respondent's Brief, *supra* note 48, at 53.

50. *Baker*, 181 Cal. App. 3d at 979-80, 226 Cal. Rptr. at 757.

Baker's attorneys briefed the issue of the proper constitutional measure of the results of an ordinance as applied,⁵¹ the court's opinion did not address this issue.

In concluding that a return on investment standard was facially constitutional, the *Fisher* court discussed the merits of several alternative standards.⁵² Specifically, the court considered the Market Value Standard, Net Operating Income Method (NOIM), and the Public Utility Investment Standard adopted by the *Baker* trial court.⁵³ The section that follows explains why each of these standards fail as a constitutional due process standard.

III. THE CONSTITUTIONAL MEASURE OF RETURN

A. *Defining the Value of Property*

The issue left open by the California Supreme Court in *Fisher* is the constitutional meaning of the "just, reasonable return on property" requirement established by the court in *Birkenfeld*.⁵⁴ In the context of reviewing facial challenges, it was sufficient for the court to limit its consideration to whether a rent ordinance permitted those administering it to avoid confiscatory results.⁵⁵ However, in order to review an ordinance as applied to a given landlord, the return permitted an individual must be compared against some constitutional measure. This section considers alternative methods to measure the constitutionality of a landlord's return.

Although there is no precedent defining the appropriate measure of return, two conclusions as to the standard's substantive content may be drawn from the California Supreme Court's opinion in *Fisher*.⁵⁶ First, the standard need not protect the landlord from a reduction of his property value caused by the imposition of controls. The court reasoned that reductions in value caused by regulation constitute a taking only when a landlord has been deprived of substantially all use of his property.⁵⁷ Second, an ordinance may not

51. See generally Respondent's Brief, *supra* note 48, at 53.

52. 37 Cal. 3d at 679-82, 693 P.2d at 289-91, 209 Cal. Rptr. at 710-12.

53. *Id.*

54. *Id.* at 682 n.35, 693 P.2d at 291 n.35, 209 Cal. Rptr. at 712 n.35.

55. *Id.*

56. *Id.* at 644, 693 P.2d at 261, 209 Cal. Rptr. at 682.

57. *Id.* at 686, 693 P.2d at 294, 209 Cal. Rptr. at 715. The court stated:

Any price setting regulation, like most other police power regulation of property rights, has the inevitable effect of reducing the value of regulated properties. But it has long been held that such a reduction in value does not by itself render the regulation unconstitutional. Police Power legislation results in confiscatory "taking" only when the owner has been deprived of substantially all reasonable use

indefinitely freeze a landlord's return at a nominal amount. The court concluded that a landlord must receive some relief from inflation in order to prevent confiscatory results.⁵⁸ Thus, a standard need not ensure that landlords are compensated for value lost in the market due to the imposition of controls, yet it must provide some increase in rents to reflect devaluation of the dollar due to inflation.

The most significant feature of any proposed standard is the value it assigns a landlord's property. This becomes apparent when one considers the calculations necessary to measure the sufficiency of a landlord's return. First, the value of the landlord's property must be determined.⁵⁹ This value must then be multiplied by the rate of return permitted by the ordinance.⁶⁰ The resulting figure represents a landlord's constitutionally required return.⁶¹ A constitutional return is then compared to the return the landlord actually received under the ordinance.⁶² A landlord is entitled to relief if his actual return is less than that constitutionally required.

The importance of the value attached to property can best be illustrated by example. Assume a landlord purchases a building in 1974 for \$100,000. In 1984, the building's value has risen to \$200,000. In 1985, the landlord realized a return of \$14,000. As-

of the property.

Id. (citing *Agins v. City of Tiburon*, 24 Cal. 3d 266, 598 P.2d 25, 157 Cal. Rptr. 372 (1979), *aff'd*, 447 U.S. 255 (1980)).

58. *Fisher*, 37 Cal. 3d at 683, 693 P.2d at 291-92, 209 Cal. Rptr. at 712-13. The court concluded: "Although defendants ordinance may properly *restrict* landlords' profits on their rental investments, it may not indefinitely *freeze* the dollar amount of those profits without eventually causing confiscatory results." *Id.*

59. The actual value assigned to a landlord's property will depend upon the constitutional standard the court selects. For example, a return on investment standard will value property based upon a landlord's actual investment. Conversely, a market value standard will value property at its fair market value.

60. In *Fisher* the court noted that "a just and reasonable return on investment is generally one commensurate with returns on investments in other enterprises having comparable risks." 37 Cal. 3d at 683, 693 P.2d at 292, 209 Cal. Rptr. at 713 (citing *Hutton Park Garden v. Town Council*, 68 N.J. 543, 350 A.2d 1 (1975)). See Comment, *Fisher v. City of Berkeley: Applying Due Process and Preemption to Rent Control Ordinances*, 16 GOLDEN GATE L. REV. 369, 391 (1986).

61. M. MOSKOVITZ, K. BAAR, D. BUCHATTER, R. JAVOR & R. SOLOMON, CALIFORNIA RESIDENTIAL LANDLORD-TENANT PRACTICE §§ 9.42-9.46 (CEB 1986) [hereinafter MOSKOVITZ]. See also Baar, *California Rent Controls: Rent Increase Standards and Fair Return*, 7 CEB REAL PROP. L. REP. 97 (1985).

62. "Actual return" as used here, is a short-hand form for net income. A landlord's net income equals his total rents minus reasonable operating expenses. The expense deductions permitted by a given ordinance will be presumed constitutional for the purpose of this analysis.

Objections to the expense deduction permitted would involve a challenge to the ordinance on its face. This section is concerned with defining a constitutional measure of the *results* of an ordinance as applied.

sume the ordinance in question permits a ten percent return on property. If property is defined to mean investment, the landlord's constitutionally required return would equal \$10,000. Thus, should he petition for an increase in rents in 1985, the rent board could properly deny his application. However, if property is defined to equal its fair market value, the landlord's constitutionally required return would equal \$20,000. In 1985, the landlord could petition the Board for an increase of \$6,000.

The following section will analyze four property value standards discussed in *Fisher*: (1) Market Value; (2) the Public Utility Investment Standard; (3) the Return on Investment Standard; and (4) the Net Operating Income Method.⁶³ For reasons to be explained, each is inappropriate as a constitutional measure of returns. This comment concludes by recommending a standard based on the value assigned property for tax purposes.

1. *The Market Value Standard*

In *Fisher*, the California Supreme Court rejected the petitioner's contention that a rent ordinance must provide for a return based on fair market value to survive a facial challenge.⁶⁴ The same factors that led the *Fisher* court to reject market value as a required administrative method compel its rejection as a constitutional measure of fair return.

The *Fisher* court rejected the Market Value Standard because of its circular reasoning. The court reasoned that:

Value is determined by rental income, the amount of which is, in turn, set according to value. . . . Use of market value as a constitutional standard would thoroughly undermine rent control, since the use of uncontrolled income potential to determine value would result in the same rents as those which would be charged in the absence of regulation.⁶⁵

The Market Value Standard was rejected in New Jersey⁶⁶ and Massachusetts⁶⁷ for similar reasons.

The Market Value Standard has also been criticized for perpet-

63. 37 Cal. 3d at 679-82, 693 P.2d at 289-91, 209 Cal. Rptr. at 710-12.

64. *Id.* at 692, 693 P.2d at 295, 209 Cal. Rptr. at 716.

65. *Id.* at 711 n.33, 693 P.2d at 290 n.33, 209 Cal. Rptr. at 680 n.33 (citing *Cotati*, 148 Cal. App. 3d 280, 195 Cal. Rptr. 825 (1983)).

66. *Helmsley*, 78 N.J. at 200, 394 A.2d at 65.

67. *Niles v. Boston Rent Control Admin.*, 6 Mass. App. Ct. 135, 374 N.E.2d 296 (1978); see generally Comment, *Rent Control and Landlord's Property Rights: The Reasonable Return Doctrine Revisited*, 33 RUTGERS U.L. REV. 165, 184-91 (1980).

uating artificially inflated rents.⁶⁸ To the extent that inflated rents are due to an imbalance in the rental market, a standard that bases value on an imbalanced market defeats the purpose of the controls.⁶⁹

2. *The Public Utility Investment Standard*

In *Baker*,⁷⁰ a California trial court adopted a measure of property value similar to that commonly employed in public utility law. Property invested in a public utility is assigned a value for the purposes of computing a return equal to the property's fair market value at the time it was dedicated to public use.⁷¹ The *Baker* trial court determined that an appropriate measure of a landlord's property is its fair market value as of the roll-back date⁷² identified in the rent control ordinance, adjusted for the effects of inflation from the roll-back date to the date of enactment of the rent control law.⁷³

Proponents of the Public Utility Investment Standard contend that use of value set at the roll back date avoids the circularity problems of a pure Market Value Standard.⁷⁴ In choosing a roll-back date, rent boards seek to identify the last time at which the rental market was in equilibrium.⁷⁵ Value as of the roll-back date, proponents contend, would not reflect increased value due to the housing shortage that the rent control law sought to remedy.⁷⁶ Proponents of this standard reason that it protects a landlord from loss of value due to the effect of inflation, yet prevents value from increasing due to the imbalance in the marketplace.⁷⁷

The Public Utility Investment Standard is flawed in two significant respects. First, utility law is concerned with fixing a rate that

68. *Cotati*, 148 Cal. App. 3d at 288-89, 195 Cal. Rptr. at 830-31. See also *Troy Hills*, 68 N.J. at 624, 350 A.2d at 44.

69. *Cotati*, 148 Cal. App. 3d at 288-89, 195 Cal. Rptr. at 830-31.

70. 181 Cal. App. 3d at 979-80, 226 Cal. Rptr. at 759. See *supra* notes 44-51 and accompanying text.

71. *But cf. Southern California Gas Co.*, 23 Cal. 3d at 474, 591 P.2d at 36, 153 Cal. Rptr. at 12.

72. Upon the enactment of rent controls, rents are commonly "rolled back" to a date when the market was perceived to be in equilibrium. This date is identified as the "roll-back date." Rents at the roll-back date are then adjusted to compensate for inflation during the period between the roll-back date and the enactment of controls. See, e.g., TENANTS RIGHTS, *supra* note 1, at § 10 (1982); SANTA MONICA, CALIFORNIA, MUNICIPAL RENT CONTROL ORDINANCE, art. XIII, § 1804(b). See generally *Birkenfeld*, 17 Cal. 3d at 166-67, 550 P.2d at 1027-28, 130 Cal. Rptr. at 491-92.

73. 181 Cal. App. 3d at 979-80, 226 Cal. Rptr. at 759-60.

74. Respondent's Brief, *supra* note 48, at 61.

75. See MOSKOVITZ, *supra* note 61, at § 9.25.

76. Respondent's Brief, *supra* note 48, at 61.

77. *Id.*

ensures economic efficiency in the operation of the public utility.⁷⁸ The sole task of the constitutional standard for measuring the landlord's return, however, is to determine the lowest constitutionally permissible rate.⁷⁹ Second, rental property is not "dedicated" for public use. Rent control laws regulate the private economic activity of a landlord. The California Supreme Court expressed similar reservations about drawing an analogy between utility and rent law in *Fisher*.⁸⁰

A final criticism of the Public Utility Investment Standard concerns the complexity of its application. The standard requires a determination of the fair market value of the rental property as of the roll-back date. Often this calculation requires costly and complicated comparisons of sales of comparable properties years before the actual time of litigation. The reasoning of the concurring opinion in *Troy Hills v. Township Council of Parsippany-Troy Hills*⁸¹ is compelling:

A local rent control agency of typically in expert part-time people, . . . needs simple, practical and inexpensively administrable rules . . . Such an agency would be ill served by resort to the complex, cumbersome, expensive and, I think, largely irrelevant techniques, procedures, and theoretical basis of the public utility rate field.⁸²

3. *The Return on Investment Standard*

The Return on Investment Standard, as commonly employed by Rent Boards, computes a landlord's return based on his investment in cash, or cash equivalents, in the rental property.⁸³

In *Fisher* the California Supreme Court held that Berkeley's

78. *Troy Hills*, 68 N.J. at 622, 350 A.2d at 43.

79. *Id.* The court stated:

However, because of the fundamental differences in the nature of the property involved and the purposes of the regulations, public utility precedents are of only limited value to the field of rent control. In particular, it should be noted that constitutional challenges to rent leveling ordinances are not rate fixing cases. Courts should not be concerned with balancing competing interests in determining what is the "best" rate level. Rather, their sole task is to determine the lowest constitutionally permissible rate.

Id.

80. 37 Cal. 3d at 681, 693 P.2d at 291, 209 Cal. Rptr. at 712.

81. 68 N.J. 604, 350 A.2d 34 (1974).

82. *Id.* at 635, 350 A.2d at 50-51.

83. See Baar, *Guidelines for Drafting Rent Control Laws: Lessons of a Decade*, 35 RUTGERS U.L. REV. 723, 792-805 (1983). See also MOSKOVITZ, *supra* note 61, at § 9.65.

"return on investment standard" was sufficiently flexible to permit non-confiscatory returns.⁸⁴ The court identified, however, several drawbacks with using a standard based on a landlord's investment to measure returns. To begin with, the court observed that strict application of an investment standard would freeze the returns of many landlords at levels recognized when rent controls were imposed.⁸⁵ The ordinance survived the landlord's facial attack because it allowed the rent board to increase a landlord's investment figure or his permitted rate of return. By making adjustments as necessary, the court reasoned, the rent board could avoid confiscatory results.⁸⁶

The *Fisher* court also recognized the difficulty in ascertaining a landlord's investment when property is acquired with little or no cash. This problem would arise when property is purchased without a cash down payment and subsequently improved with pre-inflation dollars, or is acquired through gift or inheritance. The court concluded, however, that the ordinance did not preclude the board from considering factors such as a landlord's personal labor, or the transferor's investment, which would allow a more accurate approximation of value.⁸⁷

The fundamental problem with the investment standard, as illustrated by *Fisher*, is that it will necessarily produce confiscatory results unless significant adjustments are provided for and made.⁸⁸ The purpose of the constitutional standard, however, is to judge the adequacy of an individual landlord's return produced by the administrative method a rent board chooses to set rents.⁸⁹

4. *The Net Operating Income Method*

The Net Operating Income Method presumes that the rent charged by a landlord on the roll-back date provided a fair return. The NOIM attempts to preserve the landlord's fair return by adjusting rents annually, usually by a fraction of the Consumer Price Index.⁹⁰

The NOIM fails as a constitutional measure of rents because it is based on the initial presumption that the returns permitted on a

84. 37 Cal. 3d at 683, 693 P.2d at 292, 209 Cal. Rptr. at 713 (illustration by example of how a long-term investor's returns may be frozen).

85. *Id.*

86. *Id.* at 685, 693 P.2d at 293-94, 209 Cal. Rptr. at 714-15.

87. *Id.*

88. Respondent's Brief, *supra* note 48, at 56-57.

89. See *supra* notes 54-62 and accompanying text.

90. See Baar, *supra* note 83, at 809-16. See also MOSKOVITZ, *supra* note 61, at § 9.45.

given date were constitutionally adequate.⁹¹ The constitutional standard, however, must provide a measure by which a landlord can rebut the presumption that his base rent is fair. The *Fisher* court found that the Berkeley NOIM was facially constitutional because it contained adjustment mechanisms which, if applied properly, would allow a board to avoid confiscatory results.⁹² As noted in the discussion of the Investment Standard, a standard for measuring returns that depends on proper administration by a rent board is unworkable as a constitutional standard.⁹³

B. *Summary*

The Market Value Standard, Public Utility Investment Standard, Return on Investment Standard and Net Operating Income Method all contain flaws that render them unworkable as a constitutional measure of a landlord's return. The Market Value Standard contains circular reasoning. The Public Utility Investment Standard is based on utility law precedents, which are of little value in setting a minimum level of return because utility law is concerned with finding economically optimal rates, rather than rates that would be constitutionally permissible. Both the Investment Standard and the Net Operating Income Method rely on proper administration by rent boards to prevent confiscatory results. As such, they provide little help in measuring whether the administrative method chosen by a rent board actually produced acceptable results. The section that follows will define a standard based on the assessed tax value of a landlord's property, which this comment concludes is the best measure of a landlord's return.

IV. THE ASSESSED VALUE STANDARD

A. *General Application*

The Assessed Value Standard proposed by this comment assigns to a landlord's property a value equal to the assessed value recognized by local government for tax purposes. Put simply, this standard would compare the assessed value, multiplied by the rate of return permitted by a rent board, with the actual return the landlord currently receives. Proof that a rent board has assigned a value to property below its assessed value would entitle a landlord to relief.

91. Respondent's Brief, *supra* note 48, at 66.

92. 37 Cal. 3d at 683, 693 P.2d at 292-93, 209 Cal. Rptr. at 712-13.

93. See *supra* notes 87-89 and accompanying text.

For example, assume a landlord purchased his building in 1965 for \$50,000. The same building now has a current value of \$200,000 and is assessed at \$150,000. Further, assume the local rent board allows landlords a ten percent return on their investment. Using the Assessed Value Standard for measuring fair return, the landlord's minimum constitutional return would equal \$15,000 (ten percent of \$150,000). A return of \$5,000 (ten percent of the landlord's investment) would be constitutionally deficient. By the same token, if the landlord requested a return of \$20,000, based on the current market value of his property, his request would be denied.

B. *Property Assessment in California*

The Assessed Value Standard is particularly attractive for use in California due to the unique manner in which California assesses property. Proposition 13, adopted by California voters in 1978, redefined the manner in which property is assessed.⁹⁴ Assessed value in California is based on the property's fair market value in 1975.⁹⁵ The 1975 base value is increased each year by the lesser of the rise in the consumer price index or two percent.⁹⁶ Property is reassessed only upon purchase, new construction or a change in ownership.⁹⁷

94. CAL. CONST. art. XIII A, §§ 1, 2 provides in pertinent part:

Section 1. (a) The maximum amount of any ad valorem tax on real property shall not exceed one percent (1%) of the full cash value of such property. The one percent (1%) tax to be collected by the counties and apportioned according to law to the districts within the counties.

(b) The limitation provided for in subdivision (a) shall not apply to ad valorem taxes or special assessments to pay the interest and redemption charges on (1) any indebtedness approved on or after July 1, 1978, by two-thirds of the votes cast by the voters voting on the proposition.

Section 2. (a) The full cash value means the county assessor's valuation of real property as shown on the 1975-76 tax bill under 'full cash value' or, thereafter, the appraised value of real property when purchased, newly constructed, or a change in ownership has occurred after the 1975 assessment. All real property not already assessed up to the 1975-76 full cash value may be reassessed to reflect that valuation. . . .

(b) The full cash value base may reflect from year to year the inflationary rate not to exceed 2 percent (2%) for any given year or reduction as shown in the consumer price index or comparable data for the area under taxing jurisdiction. . . .

Id. For a general discussion of the social and economic impact of Proposition 13, see D. DOERR, *THE PROPERTY TAX FOUR YEARS AFTER PROPOSITION 13*, ASSEMBLY REVENUE AND TAXATION COMMITTEE REPORT FOR JOINT COMMITTEE INTERIM HEARING, at 2 (1982).

95. CAL. REV. & TAX CODE § 110.1 (West Supp. 1987).

96. *Id.*

97. *Id.* For a discussion of how the Assessed Value Standard applies to property reassessed after purchase or a change in ownership, see *infra* notes 107-12 and accompanying text.

Although assessed value is initially based on fair market value, all subsequent increases in assessed value are limited to two percent, a figure deemed reasonable by the voters of California. Because increases in assessed value are limited by statute, the assessed value of property is insulated from forces in the rental market, such as scarcity, that increase the actual market value of rental property. Thus, the circularity problem associated with the Market Value Standard is eliminated.⁹⁸

The Assessed Value Standard would also efficiently resolve the "inflation" issue left open in *Fisher*.⁹⁹ The *Fisher* court concluded that an ordinance that allows no adjustment for inflation would ultimately produce confiscatory results. The court declined to state, however, what adjustment for inflation is constitutionally required. The Assessed Value Standard would afford landlords protection against inflation only to the extent that they are unprotected for tax purposes. Each year, assuming the rate of inflation equals or exceeds two percent, landlords would be eligible for a two percent increase in property value to reflect the increase in their tax liability caused by inflation.

C. *Application of the Assessed Value Standard in Other Jurisdictions*

In *City of Miami v. Forte Towers, Inc.*,¹⁰⁰ the Florida Supreme Court rejected a rent adjustment standard based on assessed value. The court concluded that the standard would deprive landlords of a fair return on the value of their property.¹⁰¹ The court based its opinion on evidence that indicated that despite a requirement that property be assessed at 100% of current market value, the average assessment in Miami reflected only 75% of the property's actual value.¹⁰² The court concluded that an ordinance based on assessed value would produce confiscatory results because landlords would be deprived a return that reflected the actual *market* value of their property.

As noted previously, the notion that returns must reflect market

98. See *supra* notes 65-69 and accompanying text.

99. 37 Cal. 3d at 683, 693 P.2d at 291-92, 209 Cal. Rptr. at 712-13.

100. 305 So. 2d 764 (Fla. 1974). The Miami ordinance rejected by the Florida Supreme Court based return on assessed value as of 1973. The ordinance allowed landlords a net annual return of six percent on this value. *Id.* at 769.

101. *Id.* at 769.

102. *Id.*

value has been rejected by all recent rent control decisions.¹⁰³ The Florida Supreme Court based its decision on the assumption that return on value was constitutionally required. The California Supreme Court in *Fisher* held that such a standard was not constitutionally required.¹⁰⁴

The New Jersey Supreme Court criticized the Assessed Value Standard in *Helmsley v. Borough of Fort Lee*,¹⁰⁵ reasoning that such a standard would involve the same circularity problems caused by applying a market value standard because rental property is often assessed through methods based on the property's income stream.¹⁰⁶ As noted, in California property is assessed based on its value in 1975, adjusted two percent per year to reflect the effects of inflation. Although the initial assessment reflects market value, the present assessed value reflects a value independent of the forces of the marketplace. The assessed value in 1975 operates much like a "roll back date." It reflects a value insulated from the housing shortages of the late 1970's. As such, returns would be unaffected by the market forces that produced the inflated rents that controls seek to remedy.

D. *The Assessed Value Standard as Applied to Property After Purchase or a Change in Ownership*

This comment concludes that the fairness of rents paid by tenants living in a building that is sold must be calculated according to the assessed value of the building before its sale. As noted previously, in California, property is reassessed upon purchase or a change in ownership. For reasons described below, this comment concludes that new owners should be permitted to increase rents to reflect "reassessed value" only after apartments are voluntarily¹⁰⁷ vacated.

If the fairness of rent received from existing tenants by a new owner is measured according to reassessed value, a new owner may be entitled to immediate rent increases.¹⁰⁸ Allowing such increases would defeat two commonly stated goals of rent control: (1) the need

103. See *supra* notes 64-67.

104. See *supra* note 52 and accompanying text.

105. 78 N.J. at 209-10, 394 A.2d at 70.

106. *Id.* at 209, 394 A.2d at 70.

107. Landlords would not be permitted to raise rents after evicting tenants (without good cause), or otherwise pressuring tenants to leave.

108. If the previous owner was actually receiving a return above the constitutional return merited by the pre-sale assessed value of his property, reassessment of the property may not result in rent increases.

to protect long-term tenants living on fixed incomes; and (2) the discouragement of speculative property transfers by landlords.¹⁰⁹

Rent controls seek to protect low income renters who would be forced to move out of their homes by rising rents.¹¹⁰ If a new owner is permitted to raise rents as soon as his property is reassessed to current market value, tenants unable to afford higher rents would be forced to relocate. Measuring the fairness of rents according to pre-sale assessed value would prevent immediate increases, thus protecting low income tenants.

Measuring rents according to pre-sale assessed value would also discourage speculative property transfers. Many cities, in enacting control ordinances, have identified speculative purchases of rental property as a cause of inflated rents.¹¹¹ If rents are measured according to reassessed value, thus permitting immediate rent increases, the new owner would be willing to pay more for a building than he would if the building's income was restricted to the previous controlled level.¹¹² The result would be inflated property values and ever increasing rents.

This comment concludes that the fairness of rent received from a tenant should be measured by the assessed value of the property at the time the tenant agrees to rent a unit. Rent paid by existing tenants would be unaffected by a subsequent sale and reassessment. However, as units are voluntarily vacated after a sale, the new owner would be allowed to increase the rent of the vacated unit to reflect the building's current assessed value.

Applying the Assessed Value Standard in this manner would force potential buyers to take into account current limitations upon the building's income imposed by rent controls. Should he choose to invest in the building, he does so knowing that his return will be based upon the building's pre-sale assessed value. A landlord, however, should not be expected to accept returns based on the previous owner's tax base indefinitely. As units become vacant, it is fair to allow him to charge new tenants rents based on the value used to determine his current tax liability.

109. See MOSKOVITZ, *supra* note 61, at § 9.2.

110. *Id.*

111. See, e.g., SANTA MONICA, CALIFORNIA, MUNICIPAL RENT CONTROL ORDINANCE, art. XIII, § 1800 (1985).

112. In *Troy Hills*, the court stated that, "rent levels may permissibly . . . preclude persons who have paid inflated purchase prices for buildings from recovering a fair return." 68 N.J. at 628, 350 A.2d at 47.

E. Summary

The Assessed Value Standard is easy to use and produces results that are fair. Assessed value is a matter of public record. To determine a landlord's constitutionally permissible return, a board need only look up his assessed value and multiply it by the rate of return permitted by the rent board.

In addition, the results produced by the Assessed Value Standard are equitable. Local governments are precluded from defining one value of property for purposes of determining its own tax income, and another when defining a landlord's permissible return. By the same token, landlords will be unable to assert their returns are confiscatory when they pay taxes on a value below that alleged necessary to receive a fair return.

V. CONCLUSION

The California Supreme Court has yet to define the constitutional standard by which it will measure the sufficiency of a landlord's return. The court identified the need for a standard in *Fisher*, but concluded it would be improper to define a standard until it was faced with a challenge to rent control as applied.

This comment defines a standard that links permissible return to a landlord's property tax liability. The standard applies a value to the landlord's property for rent purposes equal to the value upon which a landlord's taxes are based. In cases where property is reassessed due to a purchase or a change in ownership, the assessed value of the property *prior to sale* is used to measure the fairness of rent received from tenants in occupation at the time of the ownership change.

In the absence of a clearly defined constitutional measure of fair return, disputes between landlords and local rent boards will flourish. Landlords desiring higher rents will take their grievances to court. The Assessed Value Standard proposed by this comment provides a simple, efficient means for landlords and rent boards to measure the sufficiency of returns permitted by a local rent control ordinance. Adoption of the Assessed Value Standard by the California courts will serve the interests of both renters and property owners by providing a framework for the resolution of rent disputes.

Jonathan M. Ross

